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P 170917Z DEC 09
FM AMEMBASSY BAGHDAD
TO RUEHC/SECSTATE WASHDC PRIORITY 5785
INFO RUCNRAQ/IRAQ COLLECTIVE PRIORITY
RUEHC/OPEC COLLECTIVE PRIORITY
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RHEBAAA/USDOE WASHDC PRIORITY
RUEKJCS/DIA WASHDC PRIORITY
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C O N F I D E N T I A L SECTION 01 OF 02 BAGHDAD 003257

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E.O. 12958: DECL: 12/17/2019
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SUBJECT: IRAQ'S OIL BID ROUND 2: CAN IRAQ FULFILL THE
PROMISE?

REF: BAGHDAD 3196

Classified By: DCM Robert Ford for reasons 1.5 b,d

11. (SBU) Summary: Iraq's proposal to increase national oil production from 2.5 million barrels per day to perhaps as high as 12 million barrels per day is extremely aggressive and delivering on that promise poses significant challenges. These challenges include: limited project management capability; an uncertain regulatory environment; deteriorating and inadequate on-shore and off-shore infrastructure; concerns over physical security; potential limited availability of equipment and materiel; and concerns over the sanctity of contracts. Under the best of circumstances, reaching production of 12 million barrels per day would be tough. If Iraq were to attain only half that, it would still be a remarkable technical achievement, a sea-change in economic outlook, and a transformative event in the modern history of Iraq. But in order for Iraq get to those production rates of 6 million barrels per day or more, it will have to change a lot about the way it does business.

12. (U) This cable is one in a series analyzing the impacts of Iraq's Second Petroleum Licensing Round ("bid round"), held December 11-12 in Baghdad. (This cable also incorporates results from the first bid round held on June 30.) Results of the second bid round are detailed extensively in reftel. This cable examines the challenges (notably infrastructure) to attaining the ambitious production targets set by Iraq's two bid rounds. Other cables in this series analyze the impact on Iraq's investment climate, implications for OPEC, impacts on domestic and sectarian politics, and the participation of U.S. firms. End Summary.

Quadrupling Production: Can it be Done?

13. (C) Based solely on the magnitude of the awarded bids from the June and December bid rounds, Iraq's total oil production could conceivably rise to 12 million barrels per day (bpd) within ten years. If it attains such production increases, Iraq could jump from the 11th largest oil producer to the world's largest oil producer and from the 10th largest oil exporter to the world's largest oil exporter. But a bid is not a contract, and a contract is not a completed project. Can Iraq actually pull this off? The challenges will be enormous, and include:

-- Project management: Under the terms of the contracts, the MOO has a 25 percent share in all projects and is a co-manager. It arguably lacks the project management capacity to implement even one major project (for example, reconstruction of the Al Faw tank farm has languished for years). The Ministry by no means has the capacity to manage

the scope and number of simultaneous development projects it has just agreed to undertake as part of this bid process.

-- Regulatory environment: The GOI is not prepared for the pace and scope of work that these oil development projects will require. From permits to visas to customs clearances, every GOI office and service will need to become significantly more adept and efficient at its duties if these projects are to move forward smoothly. One of the key changes needed will be the separation of the national oil company from the Ministry of Oil and the designation and delineation of regulatory responsibilities of a new (smaller) MOO. Draft legislation to implement such reforms must be updated, enhanced, and passed.

-- Offshore infrastructure: Currently 80 percent of Iraq's exports flow through just two pipelines to the Al Basrah Oil Terminal (ABOT). The two deteriorating sub-sea pipelines are 15 years beyond their life expectancy, and represent a single point of failure for the entire Iraqi economy. A catastrophic failure of one of these lines would send millions of barrels of crude into the Arabian Gulf, creating an environmental disaster, fouling desalinization plants throughout the Gulf states, and costing Iraq billions of dollars in lost revenues. A USD 1.7 billion project to replace these lines is underway, but schedules have already begun to slip and funding remains uncertain. Even if completed as designed and on schedule, the new expanded project will accommodate only 4.5 million barrels per day of exports. If the project were to be expanded, this could increase to 6 million barrels per day. Clearly, with 10 to

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12 million barrels per day of potential production in its future, the GOI must begin planning now for multiple additional export routes, including starting design and construction in conjunction with the international oil companies (IOCs) coming into southern Iraq.

-- Onshore infrastructure: Connecting the fields -- which will be developed by the IOCs working with the Iraqi oil company -- with the offshore export facilities described above will require dramatically enhanced and expanded on-shore facilities (e.g., pipelines, water handling, pump stations, tank farms). These are multi-billion dollar projects in their own right, and are subject to the same challenges (such as financing and project management) outlined above. Because IOCs are not in most cases responsible for these projects, they will fall to the GOI, which thus far has not demonstrated the desired sense of urgency to launch and execute these projects. We expect the IOCs will of necessity become involved in these projects, though there could be some contentious negotiation over financing and reimbursement. Indeed, our conversations with the companies make clear they are already thinking along these lines.

-- Oil services and equipment: If oil prices rise markedly again, it will likely prompt significantly greater international demand for oil rigs and related oilfield services inputs, as happened in winter 2006-summer 2007. In private discussions, IOCs have told us that they expect to be able to obtain sufficient materiel and manpower to develop their fields. However, the sheer scale of rapid development in so many fields at the same time could pose scheduling and budget problems. Any delays related to service and equipment companies could skew exploration and pre-production schedules, with knock-on consequences for production and ultimately profitability.

-- Political/physical security: If the political and or security situation in Iraq were to worsen, it would almost certainly delay efforts to ramp up production.

-- Respect for contracts: Iraq is entering this kind of

relationship with foreign oil companies for the first time in decades. While nationalist protests against these relationships have become more muted, Iraqi leaders will always be sensitive to any suggestions they are sacrificing Iraqi sovereignty or not getting the best possible deal. If the GOI were to respond to such suggestions by attempting to alter agreed contracts, Iraq's credibility would be severely harmed and oil sector development hampered.

¶4. (C) Conclusion: Proposing to increase national oil production from 2.5 million barrels per day to perhaps as high as 12 million barrels per day is extremely aggressive, and poses a number of challenges. In addition to the political and technical challenges outlined above, companies must also contend with changes in the price of oil, availability of credit, interest rate fluctuations, consumer demand, and myriad other variables that could call their business projections into question. These risks should not be underestimated, and they help explain why over half of those companies eligible to bid on Iraqi oil fields in the second round chose not to do so.

¶5. (C) Conclusion cont'd: Under the best of circumstances, reaching production of 12 million barrels per day would be Qreaching production of 12 million barrels per day would be tough. If Iraq were to attain only half that, it would still be a remarkable technical achievement, a sea-change in economic outlook, and a transformative event in the modern history of Iraq. But in order for Iraq get to those production rates of 6 million barrels per day or more, it will have to change a lot about the way it does business. It will have to energize refurbishment of aging export infrastructure in the South, genuinely respect contracts, and seriously plan and implement new infrastructure projects, none of which it does well now. In other words, to deliver on the promise of the two recent oil bid rounds, Iraq,s government has to start addressing these challenges now.
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